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NATO CONFIDENTIAL FROM WASHINGTON

POLITICAL ANALYSIS: IMPLICATIONS OF NEW CEMA PRICING
SYSTEM FOR SOVIET/EAST EUROPEAN RELATIONS

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1. BEGIN SUMMARY: THE COUNCIL FOR MUTUAL ECONOMIC
ASSISTANCE (CEMA) HAS AGREED UPON A NEW PRICING SYSTEM
FOR INTRA-CEMA TRADE FOR THE PERIOD 1976-80. UNDER
THE NEW SYSTEM PRICES WILL BE ADJUSTED ANNUALLY AND THE

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PRICE BASE WILL BE THE AVERAGE OF WORLD MARKET PRICES FOR THE PRECEDING FIVE YEARS. THE ANNUAL ADJUSTMENT IS THE GREATER INNOVATION--IN THE PAST, PRICES HAD BEEN FIXED FOR AN ENTIRE FIVE-YEAR PERIOD.

2. THE NEW SYSTEM, WHICH IS ALREADY BEING PARTIALLY APPLIED TO 1975 TRADE, RAISES THE PRICE OF RAW MATERIALS AND ENERGY RESOURCES CONSIDERABLY MORE THAN THAT OF

MANUFACTURED GOODS AND REPRESENTS A SHIFT IN THE TERMS OF TRADE IN FAVOR OF THE SOVIET UNION.

3. TO PAY FOR HIGHER PRICED SOVIET RAW MATERIALS AND ENERGY RESOURCES, EAST EUROPEAN COUNTRIES WILL HAVE TO DIRECT A GREATER PORTION OF THEIR QUALITY GOODS TO THE USSR. THIS HAS SIGNIFICANT IMPLICATIONS FOR THE FUTURE OF THE STANDARD OF LIVING IN THESE COUNTRIES (NOT ALL OF WHICH WILL SUFFER TO THE SAME DEGREE, OWING TO DIFFERENCES IN RESOURCE ENDOWMENTS) AS WELL AS FOR THE FUTURE OF CEMA INTEGRATION.

(A)--IT IS CLEAR THAT THE SOVIETS INTEND TO USE THEIR IMPROVED TRADE POSITION TO INVOLVE THE CEMA COUNTRIES MORE CLOSELY IN SOVIET ECONOMIC DEVELOPMENT, ESPECIALLY RESOURCE DEVELOPMENT. IT REMAINS TO BE SEEN WHETHER THE SOVIETS WILL BE ABLE TO TAKE ADVANTAGE OF THIS--POSSIBLY TEMPORARY--INCREASE IN SOVIET/EAST EUROPEAN INTER-DEPENDENCE TO EFFECT GREATER AND LASTING CEMA INTEGRATION.

(B)--ALTHOUGH THEIR TERMS OF TRADE HAVE WORSENED, THE EAST EUROPEAN COUNTRIES CONTINUE TO DERIVE BENEFITS FROM THEIR TRADING RELATIONSHIP WITH THE USSR. THE HIGHER PRICES THAT THEY MUST PAY FOR SOVIET EXPORTS ARE STILL WELL BELOW WORLD MARKET PRICES.

(C)--THE SOVIET UNION, WHILE DESIRING TO BENEFIT FROM PRICE INCREASES IN ITS EXPORTS, RECOGNIZES THAT THE CONFIDENTIAL

POLITICAL STABILITY OF ITS EAST EUROPEAN ALLIES COULD BE JEOPARDIZED BY A DETERIORATION IN THOSE COUNTRIES' STANDARDS OF LIVING. TO AVOID TOO RADICAL A SHIFT IN THE TERMS OF TRADE, THE SOVIET UNION IS WILLING NOT ONLY TO KEEP PRICES FOR ITS ALLIES WELL BELO' WORLD MARKET PRICES BUT ALSO TO EXTEND 10-YEAR CREDITS TO THEM TO HELP THEM MAKE THE NECESSARY ADJUSTMENTS GRADUALLY. END SUMMARY.

4. THE NEW SYSTEM COMPARED WITH THE OLD: PREVIOUSLY, CEMA PRICES HAD BEEN FIXED FOR ENTIRE FIVE-YEAR-PLAN PERIODS, BASED ON AN AVERAGE OF WORLD MARKET PRICES. FOR THE CURRENT FIVE-YEAR PLAN (1971-75), PRICES WERE BASED

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ON WORLD MARKET PRICES DURING THE PERIOD 1965-69.

5. IN RECENT YEARS THE OLD SYSTEM WAS NOT QUITE AS INFLEXIBLE AS IT HAD ONCE BEEN. THE FIXED CEMA PRICE APPARENTLY APPLIED ONLY TO THOSE DELIVERIES AGREED UPON IN THE ANNUAL TRADE PROTOCOLS. DELIVERIES ABOVE THIS AGREED-UPON FIGURE,WHICH COULD BE SIGNIFICANT, FREQUENTLY

WERE VALUED AT CURRENT WORLD MARKET PRICES AND OFTEN WERE PAID FOR IN HARD CURRENCY OR ITS EQUIVALENT.

6. THE CEMA COUNTRIES PRAISED THEIR SYSTEM AS ONE THAT PROVIDED STABILITY IN THEIR FOREIGN TRADE. AS INFLA-TIONARY PRESSURES IN THE FREE MARKET INCREASED, HOWEVER, CEMA PRICES GOT FURTHER AND FURTHER OUT OF LINE WITH WORLD PRICES, MUCH TO THE DISADVANTAGE OF THE SOVIET UNION.

7. THE 70TH CEMA EXECUTIVE COMMITTEE MEETING, HELD IN MOSCOW JANUARY 21-23, DECIDED TO CHANGE THE CEMA PRICING SYSTEM TO TAKE INTO ACCOUNT RAPID INFLATION IN THE WORLD MARKET. FOR THE NEXT FIVE-YEAR PERIOD, CEMA PRICES WILL BE SET ANNUALLY AND WILL BE BASED ON THE AVERAGE OF WORLD MARKET PRICES IN THE PRECEDING FIVE YEARS. PRICES IN 1976 WILL BE BASED ON THE AVERAGE OF 1971-75 WORLD MARKET PRICES.

(A)--SOME COMMENTATORS, INCLUDING JOZSEF BIRO, HUNGARIAN CONFIDENTIAL

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MINISTER OF FOREIGN TRADE, HAVE STATED THAT THIS AVERAG-ING OF PRICES FORMS ONLY A BASIS FOR CEMA PRICES, WHICH ARE ADJUSTED TO TAKE INTO ACCOUNT MONOPOLISTIC PRICING PRACTICES FOUND IN MARKET ECONOMIES.

(B)--IN AN INTERVIEW IN NEUES DEUTSCHLAND, DR. GERHARD WEISS, THE GDR'S PERMANENT CEMA REPRESENTATIVE, INDICATED THAT THE AVERAGING OF PRICES ITSELF SERVES AS THE ADJUST-MENT MECHANISM.

8. IMMEDIATE APPLICATION: THE SOVIET UNION SOUGHT TO APPLY THE NEW PRICING SYSTEM TO INTRA-CEMA TRADE IN 1975, A YEAR BEFORE THE EXECUTIVE COMMITTEE INTENDED IT TO GO INTO EFFECT. AFTER SOME HEAVY BARGAINING OVER THE EXTENT TO WHICH THE NEW SYSTEM SHOULD BE PUT IN OPERATION, THE SOVIET UNION'S CEMA TRADING PARTNERS ACCEPTED THE PRINCIPLE THAT SOME IMMEDIATE ADJUSTMENTS WERE NEEDED. ALL THE 1975 TRADE PROTOCOLS CALL FOR ADJUSTMENTS AS OF JANUARY 1.

9. HUNGARY HAS REPORTED IN GREATEST DETAIL TO DATE ON THE NEW SYSTEM:

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(A)--A THREE-YEAR AVERAGE HAS BEEN USED TO DETERMINE PRICES IN CATEGORIES OF GOODS ACCOUNTING FOR 56 PERCENT (IN VALUE TERMS) OF HUNGARIAN IMPORTS FROM AND 63 PERCENT OF HUNGARIAN EXPORTS TO THE SOVIET UNION IN 1975.

(B)--THE GREATEST ADJUSTMENTS IN PRICES OF HUNGARIAN IMPORTS ARE IN RAW MATERIALS AND ENERGY RESOURCES, WHERE THE AVERAGE INCREASE IS 52 PERCENT. IMPORTED MACHINERY AND EQUIPMENT HAVE INCREASED, ON AVERAGE, ONLY 3.3 PERCENT.

(C)--THE LARGEST SINGLE PRICE INCREASE UNDOUBTEDLY IS IN SOVIET OIL, WHICH HAS GONE FROM 16 TO 37 RUBLES A TON, A JUMP OF MORE THAN 130 PERCENT.

(D)--HUNGARIAN EXPORT PRICES HAVE ALSO RISEN--AN AVERAGE OF 15 PERCENT FOR MACHINERY AND EQUIPMENT AND 28 PERCENT FOR AGRICULTURAL PRODUCTS--BUT, ON BALANCE, THE TERMS OF CONFIDENTIAL

TRADE HAVE DEFINITELY SHIFTED IN FAVOR OF THE SOVIET UNION.

10. FACTORS OF SIGNIFICANCE FOR CEMA INTEGRATION: THE USSR, AS PRINCIPAL SUPPLIER OF MOST RAW MATERIALS AND IMPORTED ENERGY RESOURCES TO EASTERN EUROPE, HAS NOT ONLY IMPROVED ITS BALANCE OF TRADE WITH THE OTHER MEMBERS OF CEMA; IT HAS ALSO REINFORCED ITS POSITION OF LEADERSHIP IN THAT ORGANIZATION. IT REMAINS WILLING, FOR POLITICAL REASONS, TO SUPPLY CEMA MEMBERS WITH SUBSTANTIAL QUANTITIES OF GOODS AT PRICES WELL BELOW WORLD MARKET PRICES:

(A)--FOR SOVIET OIL, THE EAST EUROPEANS PAY LESS THAN HALF OF THE CURRENT WORLD MARKET PRICE (WHEN TRANSPORTATION COSTS AND COMPANY PROFITS ARE TAKEN INTO ACCOUNT).

(B)--FOR STEEL AND PIG IRON, THE WORLD MARKET PRICE IN US DOLS REPORTEDLY IS 1 1/2 TIMES THE SOVIET RUBLE PRICE FOR ITS ALLIES, FOR SUPERPHOSPHATE IT IS TWO TIMES, FOR WOOD PULP IT IS 2 1/2 TIMES.

11. THE USSR HAS ALSO AGREED TO INCREASE DELIVERIES OF MANY OF THESE ITEMS TO ITS CEMA PARTNERS. THE HUNGARIANS WILL RECEIVE ADDITIONAL QUANTITIES OF LUMBER, NATURAL GAS, POTASSIUM FERTILIZER, APATITE, SULPHURIC ACID, AND KEROSENE WHICH THEY SAY WOULD COST 50 MILLION DOLS IF PURCHASED IN THE WORLD MARKET. (WE DO NOT KNOW WHETHER THESE ABOVE-PROTOCOL DELIVERIES ARE ON THE SAME PRICE TERMS AS PROTOCOL DELIVERIES. THE HUNGARIANS ARE IMPLYING THAT THEY ARE AT LESS THAN WORLD MARKET PRICES.)

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12. MORE IMPORTANT, THE SOVIETS WILL DELIVER TO THE HUNGARIANS 760,000 TONS OF CRUDE OIL OVER AND ABOVE THE 6 MILLION TONS PREVIOUSLY AGREED TO. HUNGARY WILL PAY FOR THE ADDITIONAL OIL THROUGH DELIVERY TO THE USSR OF GOODS WHICH HUNGARY WILL PURCHASE IN THIRD COUNTRIES. THIS PROVISION MAY INCREASE THE COST OF THE 760,000 TONS, BUT IT MAY STILL BE LESS THAN WHAT THE HUNGARIANS WOULD HAVE HAD TO PAY IN THE WORLD MARKET.

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13. AN IMPORTANT FEATURE OF THESE NEW AGREEMENTS AND THE TURN IN THE TERMS OF TRADE WHICH THEY REPRESENT IS THE ANNOUNCED SOVIET WILLINGNESS TO EXTEND 10-YEAR CREDITS ("UNDER EXTREMELY FAVORABLE TERMS") TO ITS CEMA PARTNERS. THESE CREDITS WILL ALLOW THE EAST EUROPEANS TO ADJUST GRADUALLY TO THE NEED TO INCREASE THEIR EXPORTS TO THE USSR AS PAYMENT FOR HIGHER PRICED SOVIET SUPPLIES.

14. THAT THE NEW SYSTEM CAUSES EAST EUROPEANS SOME EMBARRASSMENT IS EVIDENCED BY HUNGARIAN ATTEMPTS TO REPRESENT CERTAIN NORMAL TRADE PRACTICES AS CONCESSIONS ON THE PART OF THE SOVIET UNION. THUS, THE SOVIETS HAVE "MADE IT POSSIBLE" FOR HUNGARY TO CREDIT ITS PAST EXPORT SURPLUS WITH THE USSR AGAINST CURRENT IMPORTS. AND DELIVERIES

ORIGINALLY INTENDED AS HUNGARIAN INVESTMENT IN THE DEVELOPMENT OF SOVIET RESOURCES (WHICH WERE TO BE REPAID BY FUTURE RAW MATERIAL DELIVERIES FROM THE USSR) WILL NOW APPEAR IN THE CURRENT ACCOUNT (AND THUS CAN NO LONGER BE VIEWED AS INVESTMENTS).

15. WITH THE SHIFT IN TERMS OF TRADE, THE EAST EUROPEAN COUNTRIES WILL BE TIED CLOSER THAN EVER TO THE SOVIET UNION ECONOMICALLY.

(A)--PRESENT SOVIET DELIVERIES MUST BE PAID FOR BY FUTURE EAST EUROPEAN DELIVERIES. IT IS ALREADY EVIDENT THAT THE SOVIET UNION AND AT LEAST SOME OF THE EAST EUROPEANS SEE THIS NEW FACT OF LIFE AS LEADING INEVITABLY TO CLOSER CEMA INTEGRATION.

(B)--THE SOVIET UNION APPARENTLY HAS BEGUN TO PRESS MORE VIGOROUSLY FOR CEMA COUNTRIES' COOPERATION IN THE DEVELOPMENT OF THE SOVIET UNION'S RESOURCES. SUCH PROJECTS AS THE ORENBURG GAS PIPELINE AND THE KURSK METALLURGICAL COMPLEX ARE RECEIVING INCREASING ATTENTION AND MAY SET THE PATTERN FOR FUTURE DEVELOPMENTS.

16. EFFECT ON EASTERN EUROPE: THE REACTION ON THE EAST EUROPEAN SIDE MUST BE RATHER MIXED. ON THE ONE HAND, EAST

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FROM THE USSR AT PRICES WELL BELOW WHAT THEY WOULD OTHERWISE HAVE TO PAY IN THE WORLD MARKET WITH HARD CURRENCY. ON THE OTHER, THEIR CAPACITY FOR INCREASING THEIR TRADE WITH THE WEST HAS BEEN DIMINISHED. THEIR PROBLEMS IN TERMS OF INFLATION AND BALANCE OF TRADE RESEMBLE THOSE OF MOST WEST EUROPEAN COUNTRIES; BUT TO THE EXTENT THAT THEY ARE ABLE TO PROCURE THEIR SUPPLIES WITHIN CEMA, THEY CAN GAIN SOME BENEFITS THROUGH THE CEMA PRICING MECHANISM.

17. THE COUNTRIES OF EASTERN EUROPE ARE EXTREMELY SENSITIVE TO THE EFFECTS THAT THEIR DIMMED PROSPECTS FOR GROWTH WILL HAVE ON THE STANDARD OF LIVING OF THEIR POPULATIONS. NOT ALL ARE EQUALLY AFFECTED, HOWEVER; SOME, LIKE ROMANIA WITH ITS OIL AND POLAND WITH ITS COAL, ARE LESS DEPENDENT ON IMPORTED RAW MATERIALS AND ENERGY SOURCES THAN OTHERS. SEVERAL, INCLUDING THE GDR AND CZECHOSLOVAKIA, HAVE PROMISED TO TRY TO PREVENT THE CHANGED SITUATION FROM AFFECTING RETAIL PRICES.

18. AT BEST, HOWEVER, EAST EUROPEAN ECONOMIES WILL GROW AT A LOWER RATE THAN OTHERWISE WOULD HAVE BEEN POSSIBLE, AND THE CONSUMER SECTOR IS BOUND TO SUFFER MOST.

19. EFFECT ON THE SOVIET UNION: FOR THE SOVIET UNION, THE PICTURE IS ROSIER. THE SOVIET TERMS OF TRADE HAVE IMPROVED, NOT ONLY VIS-A-VIS ITS CEMA PARTNERS BUT ALSO VIS-A-VIS THE WEST. THE SOVIETS WILL SEEK TO INVOLVE BOTH WESTERN FIRMS AND ITS CEMA PARTNERS IN ITS FUTURE ECONOMIC DEVELOPMENT.

20. WHILE THE SOVIET UNION WILL SEEK TO IHVOLVE CEMA COUNTRIES MORE DEEPLY IN ITS INDUSTRIAL AND RESOURCE DEVELOPMENT, THESE COUNTRIES MOST LIKELY WILL ALSO BE REQUIRED TO CONTINUE TO CONTRIBUTE TO IMPROVING THE SOVIET STANDARD OF LIVING THROUGH INCREASED DELIVERIES OF CONSUMER PRODUCTS. THE SOVIET UNION HAS A STANDARD OF LIVING BELOW THAT OF MOST OF ITS CEMA ALLIES. INCREASED IMPORTS OF HIGHER QUALITY CONSUMER GOODS COULD HELP TO NARROW THE GAP. KISSINGER

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